FILED
FEB 20 1990
JOSEPH F. SPANIOL, JR.
CLERK

No. 89-1106

IN THE

Supreme Court of the United States

OCTOBER TERM, 1989

TRINOVA CORPORATION,
Petitioner,

v.

STATE OF MICHIGAN,
Respondent.

On Petition for a Writ of Certiorari to the Supreme Court of Michigan

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PETITIONER'S REPLY BRIEF

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WILSON - EPES PRINTING CO., INC. - 789-0096 - WASHINGTON, D.C. 20001

10 pp

TABLE OF CONTENTS

	Page
I. THE SBT APPORTIONMENT SCHEME TAXES EXTRATERRITORIAL VALUE	2
II. THE SBT IS IMPERMISSIBLY DISCRIMINATORY	6
CONCLUSION	7

TABLE OF AUTHORITIES

CASES:	Page
American Trucking Ass'ns v. *Scheiner*, 483 U.S. 266 (1987)	3
Boston Stock Exchange v. *State Tax Comm'n*, 429 U.S. 318 (1977)	6, 7
Complete Auto Transit, Inc. v. *Brady*, 430 U.S. 274 (1977)	1
Container Corp. v. *Franchise Tax Board*, 463 U.S. 159 (1983)	4
Exxon Corp. v. *Wisconsin Dept. of Revenue*, 447 U.S. 207 (1980)	4
Halliburton Oil Well Co. v. *Reily*, 373 U.S. 64 (1963)	7
Hans Rees' Sons, Inc. v. *North Carolina*, 283 U.S. 123 (1931)	5
Mobil Oil Corp. v. *Commissioner of Taxes*, 445 U.S. 425 (1980)	1
Mobil Oil Corp. v. *Department of Treasury*, 422 Mich. 473, 373 N.W.2d 730 (1985)	3
Moorman Mfg. Co. v. *Bair*, 437 U.S. 267 (1978)	5
Norfolk & Western Ry. v. *Missouri State Tax Comm'n*, 390 U.S. 317 (1968)	5
Wallace v. *Hines*, 253 U.S. 66 (1920)	5
Westinghouse Elec. Corp. v. *Tully*, 466 U.S. 388 (1984)	7
Wismer & Becker Contracting Engineers v. *Department of Treasury*, 146 Mich. App. 690 (1985)	3
OTHER MATERIALS:	
State Taxation of Interstate Commerce, 27 Tenn. L. Rev. 239, 242 (1960)	4

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PETITIONER'S REPLY BRIEF

The State's Brief in Opposition revives an approach to the Commerce Clause that this Court has rejected. It asks the Court to forego economic analysis in reliance on assurances from the State that the SBT taxes "business activities" or "the privilege of doing business." It ignores, and counsels the Court to ignore, "the practical effect of [the] challenged tax". *Mobil Oil Corp.* v. *Commissioner of Taxes*, 445 U.S. 425, 443 (1980). The outcome here will affect not only petitioner but also several hundred other multistate corporations with over 400 pending cases in Michigan. (Opp. 11.) These cases should be resolved not by labels but on constitutional principles that recognize economic realities. *Complete Auto Transit, Inc.* v. *Brady*, 430 U.S. 279 (1977).

I. THE SBT APPORTIONMENT SCHEME TAXES EXTRATERRITORIAL VALUE

1. The State has conceded that a direct tax on compensation would require specific allocation to the state in which the compensation was paid;[1] that compensation accounted for *all* of petitioner's tax base under the SBT (Pet. App. 54a); and that the compensation apportioned by the SBT to Michigan overstated actual Michigan compensation by nearly 40 times. (*Id.*) A confession should follow that the result is unconstittuional.

Instead the State suports the tax by ignoring the components the statute itself identifies—compensation, capital costs, and profit—and by asserting that the SBT taxes "an indivisible alloy created by fusion" of those components. (Opp. 12; see *id.* 28.) The "indivisible alloy" concept is obviously meant to put a value added tax in the same category as an income tax so as to justify the SBT's use of the traditional three-factor formula for apportioning income. The same objective is behind the State's assertion that "[v]alue added is an indivisible concept, a seemless [sic] whole incapable of precise allocation" (Opp. 13-14). But there the argument stops. The State never explains why value added is indivisible, and in fact it is not—as the statute itself demonstrates by identifying compensation, capital costs, and profit as the elements of value added.[2] Indeed, in its stipulation

[1] See Pet. 12, quoting the State's acknowledgement in the Michigan Supreme Court that a tax on compensation "would apply to a tax subject so inherently locale-specific as to require specific allocation." In this Court as well the State concedes that compensation and capital costs "are capable of geographic accounting, are locale specific." (Opp. 13.)

[2] See SBT § 9; Pet. App. 10a-12a. As the State recognizes, any value added tax using the additive method, as the SBT does, "eliminates th[e] difficulty" in "identify[ing] the components, elements or sources of the value added tax base." (Opp. 14.)

to the makeup of petitioner's tax base the State identifies the same components. (See Pet. App. 54a.)[3]

Nothing is added to the "indivisible alloy" concept by the State's repeat of the Michigan Supreme Court's view that the SBT "is a 'tax on business activity'" or "'a tax upon the privilege of conducting business activity in Michigan.'" (Opp. 6, 19-20.) These words tell us nothing, as the Court has recognized.[4] What is more telling is the State's acceptance of our description of the tax as one laid upon the value added by the taxpayer to the raw materials or products it purchases, and one measured by the contributions of the labor of its employees, the capital of its owners, and the skill of its managers. (Opp. 6-8.) Those components of the tax base define the

[3] The State's contention that "the process of manufacture results in no value added until it ends in sales" (Opp. 16), does not support its "indivisibility" argument and is wrong to boot. The SBT is a consumption-type tax, meaning that value is added by the consumption of labor and capital in the course of the product's manufacture and sale. Thus compensation will have been paid, and the wages entered into the community's economic stream, before the product even reaches the retail shelf. "The value of the labor used in production * * * is the wages paid to the laborer, and the income the worker receives for providing labor to the economy." *Mobil Oil Corp.* v. *Department of Treasury*, 422 Mich. 473, 494, 373 N.W.2d 730, 740 (1985).

Indeed, while the manufacturing process obviously comtemplates that the products will be sold, the unapportioned tax base is only trivially affected by the net income or loss from those sales. Lower sales mean lower profits but, as we have already shown, the SBT taxes value added primarily by compensation and depreciation, which are largely unaffected whether the taxpayer makes a profit or a loss. In short, "[a] value added tax taxes economic activity itself." *Wismer & Becker* v. *Department of Treasury*, 146 Mich. App. 690, 696, 382 N.W.2d 505 (1985).

[4] See *American Trucking Ass'ns* v. *Scheiner*, 483 U.S. 266, 294-295 (1987) ("In our more recent decisions we have rejected this somewhat metaphysical approach to the Commerce Clause that focused primarily on the character of the privilege rather than the practical consequences of the tax.").

tax, whether one calls it a tax on value added, or on business activity, or on an indivisible alloy. "A tax on sleeping measured by the number of pairs of shoes you have in your closet is a tax on shoes."[5] So a tax on business activity measured by compensation is a tax on compensation.

2. The tax is not saved by its pedigree. (See Opp. 5-6.) Michigan's predecessor property, net worth, and income taxes may well have been lawful, and the SBT may "retain[] the identical apportionment formula" they used, but that is irrelevant to the constitutional question whether Michigan, having decided to impose a value added tax, has adopted a method that incorrectly assigns to Michigan a grossly excessive part of that added value almost all of which was, in fact, added outside rather than inside the State.

3. Nor is it relevant that this Court has upheld formulas for apportioning among several states the corporate income of a unitary business. (Opp. 16-24.) The key to those decisions is the infeasibility of identifying, on a geographic basis or through separate cost accounting, the contributions of corporate activities in each of several states to the overall net income of a unitary business. *E.g., Container Corp.* v. *Franchise Tax Board*, 463 U.S. 159, 180-184 (1983). That principle has led the Court to reject contentions that certain specific contributions to *income* could be identified, separately allocated, and eliminated from the tax base. *E.g., Exxon Corp.* v. *Wisconsin Dept. of Revenue*, 447 U.S. 207 (1980). But those decisions are inapposite here because formulary apportionment and the unitary business principle upon which it rests are inappropriate where the tax base is precisely identifiable on a geographic basis.

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[5] *State Taxation of Interstate Commerce*, 27 Tenn. L. Rev. 239, 242 (1960).

Even if it were appropriate to apply the unitary business principle, this Court has not hestitated to invalidate the application of apportionment formulas when they result in the taxation of extraterritorial value.[6] As the Court has declared:

> "The only reason for allowing a state to look beyond its borders when it taxes the property of foreign corporations is that it may get the true value of the things within it, when they are part of an organic system of wide extent, that gives them a value above what they otherwise would possess. The purpose is not to expose the heel of the system to a mortal dart, —not, in other words, to open to taxation what is not within the state."

Wallace v. *Hines*, 253 U.S. 66, 69 (1920).

4. Nor, finally, is it relevant that the amount of tax assessed against petitioner was modest compared to its Michigan sales or that, if petitioner's view prevails, it would have a tax loss carryover. (Opp. 25-27.)[7] Modesty is not the test of constitutionality. What matters is that virtually every dollar of tax paid by petitioner represents value demonstrably added outside Michigan and that the amount of the tax results almost entirely from an inappropriate formula.[8] A tax may survive imprecision, *Moorman Mfg. Co.* v. *Bair*, 437 U.S. 267, 273

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[6] *E.g., Norfolk & Western Ry.* v. *Missouri Tax Comm'n*, 390 U.S. 317 (1968); *Hans Rees' Sons, Inc.* v. *North Carolina*, 283 U.S. 123 (1931).

[7] The State errs in finding a loss carryover of nearly $28 million. That figure represents the preapportioned tax loss. After apportionment petitioner's carryover would be about $2 million.

[8] The standard three-factor apportionment formula, wholly appropriate in an income tax context in order to divide nonsource-specific business income among states jurisdictionally entitled to tax, gives the same weight to sales (which make little or no contribution to the value added tax base) as it does to payroll and property (which make significant contributions to the tax base).

(1978), but not an error which in petitioner's case is wrong by a factor of almost 40 and is likely to be comparably disproportionate in the case of most out-of-state businesses. And there is no reason why a taxpayer may not have a loss carryover under a value added tax regime if, as here, the taxpayer suffers a sizable loss and almost all of its value adding activities occur outside the taxing jurisdiction.

In sum the State prefers labels to analysis because the economic realities are against the tax. The SBT specifies the components of the tax base. The principal ones, compensation and depreciation, can be precisely identified on a geographical basis and should be specifically allocated to the state in which they occur.

II. THE SBT IS IMPERMISSIBLY DISCRIMINATORY

The State has no real response to our showing that the SBT discriminates against out-of-state businesses. It does not challenge the factual economic analysis in our petition or offer any counter-analysis of its own. It merely says what is both true and irrelevant, that this case "does not involve tax credits and tax exemptions which favor local business." But it does involve a tax that, as we demonstrated, systematically reduces the tax base for Michigan-based companies and systematically increases the tax base for out-of-state companies. The effect is not constitutionally different from a discriminatory credit or exemption. Like those devices, the SBT should be condemned for " 'providing a direct commercial advantage to local business.' " *Boston Stock Exchange* v. *State Tax Comm'n*, 429 U.S. 318, 329 (1977) (citation omitted).[9]

* * * * *

[9] *Cf.* the statement of Michigan's Governor that a major purpose of the SBT was "to promote the development and investment of business *within* Michigan." (Pet. App. 79a; emphasis in original.)

The record evidence of misallocation and discrimination in this case establishes the SBT's unconstitutionality. The Michigan Supreme Court's contrary conclusion forgets that constitutional limitations on state tax power must be "measured in dollars and cents, not legal abstractions" (*Halliburton Oil Well Co.* v. *Reily*, 373 U.S. 64, 70 (1963)), and that a state tax must be "tax neutral." *Boston Stock Exchange*, 429 U.S. at 331; *Westinghouse Elec. Corp.* v. *Tully*, 466 U.S. 388, 406 (1984). Review by this Court will provide an occasion to clarify the states' ability to apply the three-factor apportionment formula, and will assure that this case, and the more than 400 others awaiting its outcome, are determined according to correct constitutional principles.

CONCLUSION

The petition for a writ of certiorari should be granted.

Respectfully submitted,

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February 20, 1990